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CAPITAL FORMATION

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by the staff of the

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INTRODUCTION

This pamphlet presents background information with respect to a variety of tax policies which would be beneficial to capital formation. This includes provisions contained in the House-passed bill (H.R. 10612) but is not limited to them.

The matters discussed here include the investment credit both generally and as it applies to motion picture productions, policies to encourage capital formation in the case of electric utilities, depreciation and other ways of recovering capital cost, the possible integration of the corporate and individual income taxes, the proposed increase in the corporate surtax exemption and the effect of corporate rate reductions, possible incentives to encourage employee stock ownership plans, possible modification of the net operating loss carrybacks and carryovers, and, finally, various proposals for encouraging personal savings.

In each of these areas the pamphlet describes present law and the issues presented. Where the House-passed bill contains provisions in the area referred to, these also are described briefly.

1. Investment Tax Credit

Present Law

Present law provides a 10-percent investment credit for the period beginning January 22, 1975, and ending December 31, 1976. (For the period when the basic rate is 10 percent, a corporate taxpayer may elect an 11-percent credit if an amount equal to the additional one percent is contributed to an employee stock ownership plan.) Thereafter, the rate is to revert to 7 percent (4 percent with respect to certain public utility property). The investment credit is available for: (1) tangible personal proprety; (2) other tangible property (not including a building and structural components) which is an integral part of manufacturing production, etc., or which constitutes a research or storage facility; and (3) elevators and escalators. Generally, the credit is not available with respect to property used outside the United States.

To be eligible for the credit, the property must be depreciable property with a useful life of at least 3 years. Property with a useful life of 3 or 4 years qualifies for the credit to the extent of one-third of its cost; property with a useful life of 5 or 6 years qualifies with respect to two-thirds of its cost; and property with a useful life of 7 years or more qualifies for the credit to the full extent of the property's cost. (However, in the case of used property, not more than $50,000 of cost may be taken into account by a taxpayer as qualified investment for purposes of the credit for a taxable year. For 1975 and 1976, the $50,000 limit is increased to $100,000.)

Generally, property becomes eligible for the credit when it is placed in service. The investment credit is also available before the property is placed in service, as progress expenditures are made.

The amount of the credit that a taxpayer may take in any one year cannot exceed the first $25,000 of tax liability (as otherwise computed) plus 50 percent of the tax liability in excess of $25,000. Investment credits which because of this limitation cannot be used in the current year may be carried back 3 taxable years and then carried forward 7 taxable years and used in those years to the extent permissible within the limitations applicable in those years. (In the case of public utility property, the 50-percent limit is increased to 100 percent for 1975 and 1976, 90 percent for 1977, 80 percent for 1978, 70 percent for 1979, and 60 percent for 1980.)

Present law provides for a recapture of the investment credit to the extent property is disposed of before the end of the period (that is, 3–5, 5–7, or 7 or more years) which was used in determining the amount of the credit originally allowed. In these cases the tax for the current year is increased (or unused credit carryovers are reduced) by the reductions in investment credits which would have resulted if the credit were computed on the basis of the actual useful life of the property rather than its estimated useful life.

Public utility property to which the 4-percent investment tax credit is to apply after December 31, 1976, is property used predominantly in the trade or business of furnishing or selling (1) electrical energy, water, or sewage disposal services, (2) gas through a local distribution system, or (3) telephone service, telegraph service through domestic telegraph operations, or other communications services. In general, the reduced credit applies only if the rates for these services or items are established or approved by certain types of governmental regulatory bodies.

With respect to the treatment of the investment credit of regulated companies for ratemaking purposes, special limitations are imposed on the allowance of the credit to prevent the tax benefits of the credit from immediately being passed on to the consumers. These limitations are applicable to property used predominantly in the trade or business of furnishing or selling (1) the products or services described in the preceding paragraph and 2) steam through a local distribution system (or the transportation of gas or steam by pipeline, if the rates for those businesses are subject to government regulation.

The special limitations generally provide that the investment credit is not to be available to a company with respect to any of its public utility property if any part of the credit to which it would otherwise be entitled is flowed through to income (i.e., increases the utility's income for ratemaking purposes); however, in this case the tax benefits derived from the credits may (if the regulatory commission so requires) be used to reduce the rate base, if this reduction is restored over the useful life of the property.[1]

[1] If, within 90 days after enactment of the Revenue Act of 1971 the taxpayer has so elected, then the investment credit is to be available to the taxpayer with respect to any of its public utility property if the credit to which it would otherwise be entitled is flowed through to income ratably over the useful life of the property; however, in this case there must not be any adjustment to reduce the rate base. An additional elective rule was provided to permit certain types of utilities (primarily electric utilities) to immediately flow through benefits to consumers. Immediate flow through is permitted in situations where the tax benefits of accelerated depreciation rules enacted under the

The rules with respect to the additional investment credit for 1975 and 1976 generally follow those for the 4-percent credit, as enacted in 1971.

Issues

As noted above, the investment credit has just been increased from 7 percent to 10 percent until the end of 1976. The objective of the increase was to increase capital investments in plant and equipment in a manner that would complement the stimulus provided to consumer spending. Related to this is the fact that there is a large amount of unused capacity in most industries. Business may accordingly be hesitant in view of this unused capacity to plan significant new outlays for plant and equipment. However, there usually appears to be a lag in the impact of the investment credit. In fact, there is some evidence that the effects of the 1975 Act are beginning to be realized. Also, while the effects of the credit may be modest so far this year, it may be that in the absence of the credit, real investment would have fallen even further.

Effectiveness of the investment credit.—There is some question about the effectiveness of the investment credit as a stimulus to investment. In part, this stems from the difficulties of isolating the particular cause of an increase in investment at a particular phase of the business cycle. At the trough of a recession, interest rates tend generally to be low, and the availability of more favorable financing in part may explain why investment usually rises during a recovery. Also, as the economy begins to recover from a recession, corporate profits usually rebound as a result of higher worker productivity levels. Improved internal cash flow will also then increase investment.

Diagram 1 displays quarterly new orders for general industrial machinery over the period 1962–1975. Quarterly new orders grew rapidly in the fourth quarter of 1962 and then rather modestly in 1963. After liberalization in 1964, new orders grew more rapidly. The short period of suspension of the credit evidenced a rapid decline of new orders in the last quarter of 1966. Reinstatement of the credit seems to have halted the decline, although it was not until late 1968 that new orders for general industrial equipment grew rapidly again. Repeal of the credit in 1969 witnessed a drop in quarterly orders until 1971. New orders rose for the first three quarters of 1971. However, there was a short decline in new orders after the effective date of the 1971 credit. This may reflect the possibility that business delayed new investment until the credit was enacted even though its effective date was made retroactive. The experience in 1975–76 may parallel the 1971 experience.

Compositional aspects of the credit.—Provision of the investment credit not only may affect the aggregate level of investment, but also in certain circumstances the composition of investment as well. As the

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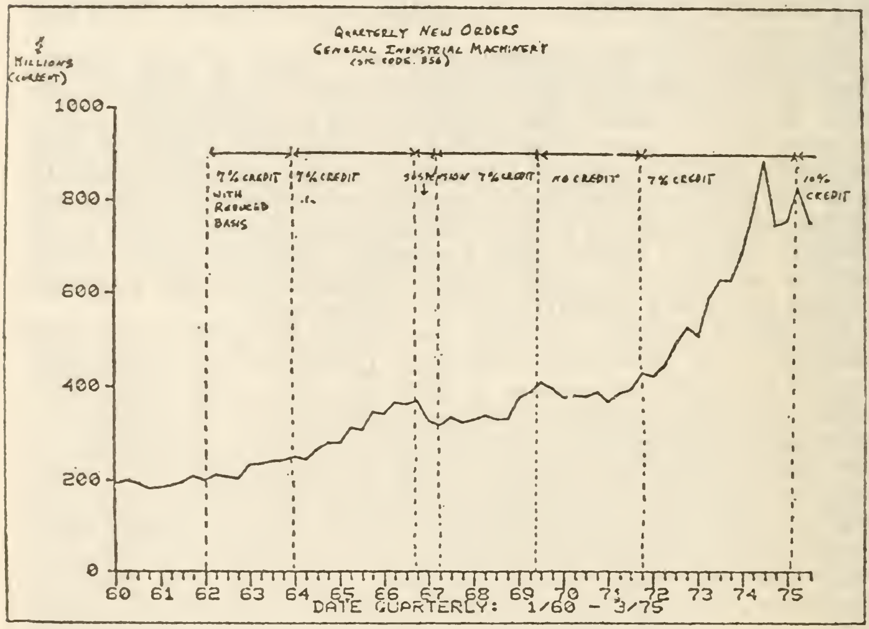
Tax Reform Act of 1969 are flowed through to consumers. This election was provided in recognition of the special competitive conditions under which a company subject to the accelerated depreciation flow-through rules was operating. A special election is provided with respect to local steam distribution systems and gas or steam pipelines where the regulatory body involved determined that the natural domestic supply of gas or steam was insufficient to meet the present and future requirements of the domestic economy. In this case, if the taxpayer elected (within 90 days after enactment of the Revenue Act of 1971) the investment credit is not to be available unless (1) no part of the credit is flowed through to income, and also (2) no part of the credit is used to reduce the rate base.

credit increases the return on investment, it alters choices for certain goods in the economy that will not, in general, benefit from the credit. For example, the credit may induce business to switch from investment in structures, which do not qualify for the credit, to investment in machinery and equipment which does qualify.

Another compositional aspect of the credit involves its utilization by different industries. The overall objective of the credit is to stimulate investment. A related objective may be to stimulate investment in those areas of the economy that are particularly depressed or those areas where subsequent bottlenecks due to capacity limitations are envisioned. If this second objective is to be pursued, consideration could be given to the possibility of providing different credits across industries, or credits that vary by geographic area.

Diagram 1



For example, it is sometimes argued that the current uniform credit does not provide the stimulus to those areas in greatest need. In this view, a credit based in part on the level of unemployment might be used to achieve national goals. Also, it has been argued that particular industries which face unusual capital requirements need greater investment credits than industries in general. A difficulty with such differentiated investment credits is that such differences based on unemployment rates in particular geographic areas, or on membership of a firm in a particular industry, could be quite difficult to measure. To the extent the investment credit based on unemployment or membership in an industry materially differed from the general investment credit, firms may attempt to modify the definitions to benefit from such credits.

Timing of credit.—Periodic review of the investment credit can create uncertainty in the business community which in turn can adversely affect the impact of the credit. If business correctly anticipates the direction of the change in the credit, substantial tax advantages may be realized. In the past 13 years, 7 decisions (approximately one every two years) have been made which have altered the provisions of the credit. Such alterations have been in response to changing economic needs to moderate or expand investment. However, to the extent such corrective action is in response to an economic problem, final action when coupled with the lagged "multiplier" effects of the credit may not provide the remedial action necessary, but rather create excessive stimulus to investment demand. Our current position in the recovery may typify such a situation. There is evidence that the recovery in the third and fourth quarters of 1976 will be reasonably strong. It would seem likely to expect that the current provision of the 10-percent credit in 1976 coupled with rising aggregate demand would encourage substantial new levels of investment. The steel industry has already announced substantial investment plans for this year.

House Bill

Under the House bill, an increase in the investment tax credit from 7 to 10 percent (from 4 to 10 percent in the case of certain public utilities) was provided through December 31, 1980. In addition, the limitation on qualified investment in used property was increased from $50,000 to $100,000 for taxable years beginning after December 31, 1974, and before January 1, 1980.

2. Investment Credit in the Case of Movie and Television Films

Present law

Under present law, taxpayers are entitled to receive an investment credit for tangible personal property which is placed in service by the taxpayer. Currently, the credit is allowed at a 10-percent rate, but is scheduled to be reduced to 7 percent beginning in 1977. As discussed above, in order to receive a full credit, the property must have a useful life of seven years and, in addition, there cannot be any predominant foreign use of the property during any taxable year, or the property will cease to qualify as section 38 property.

Prior to 1971, it was not clear whether (and if so, under what conditions) the investment credit was available for movie or television films. A court case held that movie films were tangible personal property eligible for the investment credit. In the Revenue Act of 1971, it was made clear that motion pictures and television films are to be treated as tangible personal property which is eligible for the investment credit. However, this issue is still being litigated for years prior to 1971, and there still are a number of unsettled issues, such as how to determine the useful life of a film, the basis on which the credit is to be computed, and how to determine whether there has been a predominant foreign use of the film.

Issue

Due to the uncertainties of present law with respect to the questions of useful life and predominant foreign use, it is often difficult to

determine whether a film is entitled to a full (7 or 10 percent) credit, a partial one-third or two-thirds credit, or, possibly to no credit. It would appear desirable to clear up these issues, in order to avoid costly litigation with respect to the past, and to allow accurate investment planning for the movie industry in future years.

Thus, for the past, it might be desirable to resolve these two issues on some reasonable basis. In addition, since the major purpose of the investment credit is to create jobs in the United States, some have suggested that it might be desirable to provide that for the future the amount of the investment credit in the case of movie films will depend on the place of production of the film (i.e., United States or foreign), rather than on the place where revenues are received for showing the film.

House Bill

Under the House bill, different methods would be provided to deal with the problems of the treatment of the investment credit for motion pictures and television films for the past and for the future. For the past, one of two alternatives would be available. A taxpayer under the first method (in most respects the IRS litigation position) would be eligible to receive the full credit (or any partial credit) for their films if it is demonstrated on a film-by-film basis that the film satisfied both the useful life requirement and the requirement that there must be no predominant foreign use. The useful life of the film would be treated as ending at the end of the first year in which for depreciation purposes it was estimated that 90 percent or more of the depreciable cost of the film would be recovered. A film would be treated as used predominantly in foreign markets if, in any year (and not on a cumulative basis), more than 50 percent of the gross revenues from the film resulted from showing the film abroad.

A second alternative method may be elected by a taxpayer for all years prior to 1975 (for which an investment credit was available) or only for years prior to the reenactment of the investment credit on August 15, 1971. Unless the 40-percent method described below is elected for all years prior to 1975, unused investment credits may not be carried over from years in which this method is used to any subsequent years. Under this second alternative, a taxpayer may elect to take an investment credit on the basis of 40 percent of the cost of all his films without regard to the estimated useful life of the film and also without regard to whether the film is shown predominantly outside of the United States. The credit would be based on the total costs of production, including capitalized production costs, a reasonable allocation of general overhead costs, salaries paid to the actors and production crew, costs of "first" distribution of prints, and the cost of the story being filmed. The cost for this purpose would include so-called "residuals," but in the case of participations with respect to actors or others, it would include only those which are guaranteed. Films such as news features which are essentially transitory in nature, as well as films which are produced and shown exclusively in foreign countries, would not be eligible for the credit.

In addition, any taxpayer who has received final judgment on his entitlement to the investment credit for any prior year may elect to have his right to the investment credit for all years beginning prior

to January 1, 1975, determined under present law, as interpreted by the courts, rather than by any of the alternatives set forth above.

For future years, taxpayers could elect to take an investment credit on a two-thirds basis for all films (instead of determining useful life on a film-by-film basis). The availability of the investment credit in this case would not depend on whether the film was predominantly used within the United States or in foreign countries; instead, it would depend on where the film is produced, rather than where receipts are derived from the showing of the film. Films, such as news features, which are essentially transitory in nature, would not be included in the base on which the two-thirds credit is computed.

If 80 percent or more of the direct production costs of a film are incurred in the United States, a taxpayer would be entitled to an investment credit on the same credit base as indicated above under the 40-percent method with respect to prior years, except that the credit base would not include direct expenses for foreign production or for salaries paid for services performed abroad (unless the salaries were paid to U.S. persons and were subject to U.S. tax). In determining whether this 80-percent test is met, only direct costs of production would be taken into account. (Overhead costs and the costs of screen rights, for example, would not be taken into account.)

If less than 80 percent of the production costs are incurred for U.S. production, a taxpayer could still receive a credit to the extent of direct U.S. production costs. The credit base in this case would not include such items as general overhead costs or cost of acquiring screen rights or any costs of foreign production except for salaries paid to U.S. persons subject to U.S. tax.

This two-thirds method may also be elected by taxpayers for all of their section 50 property (generally property placed in service after August 15, 1971).

The investment credit for films would be available to the persons who bear the risk of loss if the film is not a successful picture. This rule would apply under any of the alternatives set forth above.

3. Electric Utilities

The electric utilities industry faces several problems that reflect its unique role in the economy. Among major industries, electric utilities are the most capital intensive per dollar of revenue raised. The rapid increase in oil and coal prices has substantially increased the operating expenses of electric utilities. Because the industry is regulated, those utilities that are not allowed to pass on increased fuel costs automatically have experienced substantial lags recouping those increased costs through increased rates. In addition, high interest rates, reflecting in part the deteriorating financial position of the utilities and in part increased expectations of long-term inflation, have adversely affected the utilities industry by increasing their costs and pushing some utilities to the maximum debt-equity ratio allowed by State law. However, consumers and regulatory bodies have strongly resisted the increased rates necessary to reflect these higher costs if current investment plans are to be maintained. As a consequence, the financial stability of these utilities has been adversely affected.

As the pace of inflation moderates, the regulatory process may be able to allow appropriate rate increases on a more timely basis. Overhaul of the regulatory process is occurring in many States, as well as innovations in such operating procedures as peak-load pricing. In the meantime, however, there has been a substantial deferral of new investment in nuclear and coal-powered generating plants, which may result in capacity limitations in the foreseeable future.

In view of the dramatic changes in the relative prices of fuel which are used by electric utility plants to generate electricity, questions may be raised about the ability of such firms to make the very substantial capital investments. As already noted, many are unable, because of their current debt equity ratios, to utilize further debt to finance these necessary capital projects. On the other hand, their depressed profit situation has limited their ability to raise new equity.

The difficulties in the sale of new equity in part reflects the fact that dividend payments on outstanding stock are made from after-tax income. When dividends on outstanding stock do not grow or are, in fact, reduced, market reaction to new equity issues is likely to be unfavorable. The difficulty utilities have in raising dividends reflects the difficulties they have in obtaining rate changes.

Another problem which electric utilities have is that their new plants must be subject to substantial environmental regulation. Also, existing facilities must comply with such regulations. Due to the capital intensive nature of the industry, these problems have accentuated the utilities' need for further capital.

Because electric utilities are so capital intensive, and because the construction of new facilities is particularly lengthy and time-consuming, the 5-year phase-in requirement to obtain the benefit of the investment credit for "progress payments" may be too slow to properly encourage the construction of new facilities.

4. Capital Cost Recovery

Present Law

Depreciation Allowances

Under present law, a taxpayer is generally permitted to claim depreciation allowances for property used in his trade or business or held for the production of income under any of the following methods:

(1) The straight-line method of depreciation results in an equal annual expense charge for depreciation over an asset's useful life.

(2) The 200-percent declining balanace method of depreciation, more commonly referred to as double-declining balance, allows a rate equal to twice the straight-line rate. The declining balance rate is applied to the unrecovered cost, i.e., cost less accumulated depreciation for prior taxable years. Since the depreciation base is reduced to reflect prior depreciation, the amount claimed as depreciation is greater in earlier years and declines in each succeeding year of an asset's useful life.

(3) The sum of the years' digits method of depreciation is computed using a fraction the numerator of which is the years' digits in inverse order and the denominator of which is the sum of the numbers of years. As in the case of the declining balance method, the annual depreciation is greater in earlier years and declines in each succeeding year of an asset's useful life.

(4) Any other consistent method of producing an annual depreciation allowance, which, when added to all allowances for the period beginning with the taxpayer's use of the property (including the taxable year), does not exceed the total depreciation allowances which would have been taken during the first two-thirds of the useful life of the property had the double declining balance method been used.

Both the double declining balance method and the sum-of-the-years-digits method are accelerated depreciation in that they permit the taxpayer to take relatively large depreciation methods deductions in the early years of the asset's use and lower depreciation in the later years. This is generally advantageous to the taxpayer since an accelerated method of depreciation permits him to recover his capital costs more quickly than the straight-line method of depreciation.

The 1969 Tax Reform Act limited the use of rapid depreciation methods in the case of certain real estate because the use of these methods made it possible for taxpayers to deduct amounts in excess of those required to service the mortgage during the early life of the property. Under the 1969 Act, new residential housing continued to be eligible for the double declining balance or sum-of-the-years-digits depreciation methods. However, new construction other than residential housing was limited to 150 percent declining depreciation. Used realty (other than used residential property) acquired after July 24, 1969, was generally limited by the 1969 Act to straight-line or a comparable, ratable method of depreciation. Used residential property was a useful life of 20 years or more, acquired after July 24, 1969, was limited to 125 percent declining balance depreciation.

Present law also allows taxpayers acquiring personal property for use in a trade or business or for the production of income, an additional first year depreciation allowance amounting to 20 percent of the cost of the property. This extra first-year allowance applies only to the first $10,000 of the cost of property ($20,000 on a joint return) placed in service in a taxable year.

The depreciation allowances that are taken in a specific case depend in large measure on the useful life of the asset. Before 1962, business firms depreciated their property in terms of useful lives that were established for several thousand different classifications of assets (so-called Bulletin "F" lives). The guideline lives for depreciable assets that were put into effect in 1962 consolidated assets into about 75 broad asset classes and also shortened prescribed lives by up to 30 or 40 percent. The 1962 guidelines also established the use of industry classifications as distinct from classifications by type of assets.

The lives selected for use under the guidelines were determined by reference to the useful lives claimed by the taxpayers surveyed. Generally, the lives selected were the useful lives being claimed by taxpayers at the thirtieth percentile—that is, 29 percent of the assets had shorter lives and 70 percent had longer lives.

The guidelines also contained a reserve ratio test which was designed to assure that taxpayers would not be permitted continually to depreciate their assets over a period of time substantially shorter than the period of actual use. Basically, the reserve ratio test assumed that the actual useful life of assets could be determined by comparing the amount of depreciation reserves to the acquisition costs of the assets being depreciated. A built-in tolerance was contained in the

reserve ratio test to assure that the test would be met in the cases of taxpayers depreciating their assets at a rate not more than 20 percent faster than the period of their actual use of such assets.

The application of the reserve ratio test was initially suspended for three years. In 1965, the reserve ratio test was substantially modified and new transitional rules were added which had the effect of further delaying the application of the test, in most cases, until about 1971. When the Treasury Department by regulation adopted its asset depreciation range system ("ADR") in early 1971, it completely eliminated the reserve ratio test for 1971 and future years.

The Revenue Act of 1971 enacted into law the ADR system with modifications. Under this Act, the Internal Revenue Service may permit depreciation lives within the range of 20 percent above or below the class life where taxpayers elect to use the ADR system. The Act also provides a unified system of class lives which may be elected by taxpayers for assets placed in service after 1970.

Rapid 5-year amortization

In the Tax Reform Act of 1969, four provisions were enacted to make available a special 5-year amortization as an incentive to make certain investments. The types of investment made eligible for rapid amortization include (1) rehabilitation of low and moderate income housing, (2) pollution control facilities, (3) railroad rolling stock, and (4) certain coal mine safety equipment.

In general, rapid amortization was made available as an alternative to the investment tax credit that was repealed in the 1969 Act. Each of the types of investment eligible for rapid amortization was considered important to the success of an existing national policy. When the investment credit was reenacted in 1971, Congress specifically provided that the investment credit and rapid amortization both would not be available for the same investment. A taxpayer may elect either the investment credit or rapid amortization.

Amortization and Depreciation of Railroad Bores and Tunnels

Domestic railroad common carriers may amortize railroad grading and tunnel bores that were placed in service after 1968 over a 50-year period on a straight-line basis. This amortization deduction is in lieu of any depreciation or any other amortization deduction for these grading and tunnel bores for any year for which the election applies. If the taxpayer elects to use this provision, it applies to all railroad grading and tunnel bores qualified for this amortization, unless the Secretary permits the taxpayer to revoke the election. The 50-year amortization period begins the year following the year the property is placed in service.

Railroad grading and tunnel bores, for which the 50-year-amortization deduction is available, are all improvements that result from excavations (including tunneling), construction of embankments, clearings, diversions of roads and streams, sodding of slopes, and from similar work necessary to provide, construct, reconstruct, alter, protect, improve, replace or restore a roadbed or right-of-way for railroad track. Expenditures incurred from such improvements to an existing roadbed or railroad right-of-way are treated as costs incurred for property placed in service in the year in which the costs are incurred.

The railroad industry, uses for tax purposes what may be called the "retirement-replacement" method of accounting. For assets ac-

counted for under the retirement-replacement method, no ratable deduction for depreciation is claimed and no depreciation reserve is maintained. In the case of railroad track and ties, when new track is laid, the costs (both materials and labor) of the track and ties are capitalized. No depreciation is claimed on the original installation, but when the original track or ties are replaced in later years with track or ties of a like kind or quality, the costs of the replacements (both materials and labor) are deducted as current expense. This rule applies, for example, when wood crossties are replaced with new wood ties. When the replacement is of an improved quality, it is treated as a betterment, under which the betterment portion of the replacement is capitalized and the remainder is expensed. For example, if 80-pound rail is replaced with 100-pound rail, the cost of the 20-pound betterment portion is capitalized and the cost of the 80-pound replacement portion, less the salvage value of the recovered rail, is charged to expense, along with all labor costs incurred in the replacement.

A replacement with a different or improved type or kind of track or tie will, on the other hand, be treated as a retirement and substitution. Under this procedure, for example, when existing wood railroad ties are replaced with concrete ties, the Service has held (in (Rev. Rul. 68–418, 1968–2 Cum. Bull. 115) that this replacement constitutes a retirement and substitution. As a result, the material and labor costs for the new concrete ties are capitalized and the costs of the old wood ties are removed from the asset account and expensed.

Issues

Different views regarding present depreciation allowances

Questions have been raised about the adequacy of capital recovery allowances. Some hold the view that present capital recovery allowances are not adequate and interfere with the efficient operation of the economy. Others maintain that capital recovery allowances are too generous in a number of respects and, as a result, permit some businesses to secure undue tax benefits and provide inducements for the creation of tax shelter devices.

In general, those who hold that present capital recovery allowances are inadequate maintain that this inadequacy is responsible for declines in the ratio of corporate profits to gross national product which have occurred in recent years. They particularly stress the fact that the recent inflation has moved up the prices of capital goods sharply and that present capital recovery allowances which are based on historical costs do not fully allow for the replacement of the real value of the assets concerned. The result, it is claimed, is that capital formation is retarded and economic growth dampened. Another frequently expressed view is that the United States capital recovery allowances are substantially less favorable to business than capital recovery allowances in foreign countries, producing competitive disadvantages for our businessmen vis-a-vis foreign competitors, and a slower rate of economic growth for the United States as compared with foreign countries.

Adjustments for inflation

Capital recovery allowances are an important source of saving for the economy. Corporate capital recovery allowances, for example, now account for roughly about two-thirds of total gross business savings

(which also includes undistributed profits) and about 45 percent of the total gross private savings of businesses and individuals.

In dollar terms, capital recovery allowances are increasing. Capital recovery allowances are now running at an annual rate of about $85 billion—about twice the 1967 level. However, since such recovery allowances are based on the historical costs of the assets concerned, they do not make any allowance for the effect of inflation. One recent study finds that capital recovery allowances would have had to be increased $15 billion in 1974 in order to adjust for inflation.[2] Moreover, the impact of the current inflation on capital recovery allowances can be seen from the fact that the price increases occurring in 1974 alone accounted for an estimated $7 billion of the total $15 billion of indicated shortfall.

The question of whether adjustments should be permitted for tax purposes in order to take account of inflation is one that applies to areas besides capital recovery allowances. It has been argued that, while the fact that depreciation charges are not adjusted for inflation tends to result in an overstatement of profits, other factors should be taken into consideration before concluding that such an adjustment should be made.

Another aspect of this issue is whether tax adjustments for inflation should be provided for business as compared with individual taxpayers. One view is that the need to increase productive capacity requires granting such tax adjustments for certain business items, such as capital recovery allowances. Others, however, maintain that it would not be fair to provide tax adjustments for inflation to some groups and not to others.

Effect on investment

A key question is the effect capital recovery allowances have on investment in plant and equipment as well as on construction. Those who have studied this question in detail have come up with different answers. Some believe that tax policy has been highly effective in changing the level and timing of fixed investment outlays. They also find that tax policy has affected the composition of expenditures. More specifically, they find that accelerated depreciation has resulted in a shift away from equipment toward greater spending for structures while the investment tax credit tends to shift investment away from structures toward equipment. As a result, they conclude that accelerated depreciation and the investment tax credit have stimulated the level of investment very substantially.[3]

House Bill

The House-passed bill provides that taxpayers who have elected 50-year amortization for railroad grading and tunnel bores placed in service after December 31, 1968, may include in that election railroad grading and tunnel bores placed in service before January 1, 1969. The amortizable basis of pre-1969 grading and tunnel bores that were acquired or constructed after February 28, 1913, would be the adjusted basis of the property for determining capital gain in the hands of the

[2] *Correcting Taxes for Inflation,* William Fellner, Kenneth W. Clarkson and John H. Moore, American Enterprise Institute for Policy Research, Washington, D.C., pp. 27–29.

[3] *Tax Incentives and Capital Spending,* Gary Fromm, ed., (Studies of Government Finance. The Brookings Institution, 1971.)

taxpayer. For grading and tunnel bores in existence on February 28, 1913, the amortizable basis would be that ascertained by the Interstate Commerce Commission as the property's cost of reproduction new, i.e., the then current cost of reproduction. If the valuation was made by a State regulatory agency that is the counterpart of the ICC, the adjusted basis of the property would be the value of the property originally determined by the State agency (sec. 1701).

Under the House passed bill, an exception would be made to the general capitalization rules to require replacement treatment where a domestic railroad, which uses the retirement-replacement method of accounting for depreciation of its railroad track, acquires and installs replacement ties which are not made of wood. As a result, current deductions will be allowed not only where an existing railroad tie is replaced by a tie of the same material and quality, as under present law, but also where an existing tie is replaced with a tie of a different material or improved quality. This will apply, for example, where existing wood crossties are replaced with concrete or steel crossties.

5. Integration of the Corporate and Individual Income Taxes

Present Law

Under current law, individuals may exclude $100 of dividends from taxable income and families filing jointly may exclude $200 from taxable income. Corporations may deduct 85 percent of dividends received from other corporations (in certain cases 100 percent). Subchapter S corporations are taxed as partnerships; that is, partnership dividends are taxed at the individual level after application of the $100 (or $200) dividend exclusion.

Issues

The dual system of corporate and individual income taxes, which taxes corporate income at the corporate level and again at the individual level when it is received as dividends, has been charged by some with being deficient on economic efficiency and equity grounds. On efficiency grounds, it is claimed to impose a double tax on corporate income, and as a consequence to encourage capital which would otherwise flow to the corporate sector to flow to the noncorporate sector, resutling in a misallocation of resources. (This corporate-noncorporate effect has been estimated to involve from .17 to .5 percent of GNP.)[4]

On equity grounds, the present dual system of corporate and individual taxes is claimed to adversely affect recipients of corporate dividends as compared to recipients of other income because the dividend income is doubly taxed.

Also, the current deductibility of interest but not dividend payments is generally thought to bias corporate finance in favor of debt as opposed to equity. Most recently, the burden of debt on corporate balance sheets has been pronounced and integration of the corporate and individual income taxes is offered as a possible source of relief. This reflects not only the relatively depressed state of equity markets

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[4] See A. C. Harberger, "The Incidence of the Corporation Income Tax," *The Journal of Political Economy*, LXX, No. 3 and L. G. Rosenberg, "Taxation of Income from Capital by Industry Group," (in Harberger and Bailey, editors), *The Taxation of Income from Capital*. (Brookings, 1969)

but also the impact of stringent monetary policies, e.g., high interest rates.

The dual system of taxing of corporate income may be illustrated by the following example: From $100 of corporate gross income, $48 of corporate tax is paid and $52 remains and is available for distribution. If the hypothetical dividend recipient is in the 30 percent bracket, he will pay $15.60 tax on the dividends he receives as well as the initial $48 of corporate tax which the corporation in effect paid for him. His total tax bill then is $63.60. Had he beeen taxed directly on $100 income, he would have paid $30 in tax. The difference between $63.60 and $30 ($33.60), is then said to represent the extra burden of the corporate tax.

Table 1 provides illustrative calculations of the extra burden under dividend payout and no payout assumptions. Under the payout assumption, the extra burden of current taxation of $100 of corporate income is $48 for the individual with no Federal individual liability and $14.40 for the individual in the 70-percent bracket. Under the no-payout assumption, the excess burden is again $48 for the zero-tax rate person and falls to zero for the 48-percent individual. Thereafter, for individuals in tax brackets above 48 percent, the excess burden of current tax law is negative. That is, they would experience a tax increase under integration.

TABLE 1.—EXTRA BURDEN OF CORPORATE TAX UNDER ALTERNATIVE PAYOUT ASSUMPTIONS, $100 GROSS PROFITS

Marginal tax rate in percent	Total tax burden: Complete payout of earnings: Current law [2]	Integration	Burden	No payout of earnings [1]: Current law	Integration	Burden
0	$48.00	0	$48.00	$48	0	$42
14	55.28	$14	41.28	48	$14	34
15	55.80	15	40.80	48	15	33
16	56.32	16	40.32	48	16	38
17	56.84	17	39.84	48	17	31
19	57.88	19	38.88	48	19	29
22	59.44	22	37.44	48	22	26
25	61.00	25	36.00	48	25	23
28	62.56	28	34.56	48	28	20
32	64.44	32	32.64	48	32	16
36	66.72	36	30.72	48	36	12
39	68.28	39	29.28	48	39	9
42	69.84	42	27.84	48	42	6
45	71.40	45	26.40	48	45	3
48	72.96	48	24.96	48	48	0
50	74.00	50	24.00	48	50	−2
53	75.56	53	22.56	48	53	−5
55	76.60	55	21.60	48	55	−7
58	78.16	58	20.16	48	58	−10
60	79.20	60	19.20	48	60	−12
62	80.24	62	18.24	48	62	−14
64	81.28	64	17.28	48	64	−16
66	82.32	66	16.32	48	66	−18
68	83.36	68	15.36	48	68	−20
69	83.88	69	14.88	48	69	−21
70	84.40	70	14.40	48	70	−22

[1] Capital gains effects of retained earnings not considered.
[2] Ignores $100 dividend exclusion.

Several assumptions underlie this analysis. First, it is assumed that the corporate tax is paid by the corporation and ultimately by the stockholder and not by consumers through higher prices and/or by labor through lower wages. Second, it is assumed that corporate man-

agers reflect shareholder interests—that is, there is no "corporate veil." Third, it is assumed that the dividend distribution is complete. In fact, dividend distributions do not always exhaust after-tax earnings. To the extent dividend payout is low, the increase in the firm's equity should be reflected in higher stock prices. This appreciation through capital value is particularly attractive because it allows higher income investors to shelter their corporate income at the long-term capital gains tax rate rather than the rate on ordinary income.

With respect to the first assumption, that the stockholders bear the ultimate burden of the tax, there is no widespread agreement on the extent and direction of the shifting of the corporate tax. Some shifting, to consumers and employees no doubt, occurs, and varies among industries. Presumably, the extent to which the tax can be shifted depends on the behavior of consumers, the extent to which any company can influence the prices prevailing in its industry, and the bargaining power of the company vis-a-vis its employees. There would appear to be a basis for granting tax relief on grounds of double taxation of dividend income to the extent that the burden of the corporate income tax falls on stockholders and on the grounds that the tax is a discriminatory excise tax to the extent it is passed on in prices.

There is another perspective on the corporate and individual taxes which views the corporation and shareholder as related, but separate entities. In this view, the corporation by virtue of its separate standing and perpetuity under law, and the limited liability of it shareholders, derives certain benefits which are the proper base for taxation. Also, some maintain that separate taxes on corporations and individuals favorably diversifies our tax base.

Integration of the corporate and individual income taxes involves eliminating this possible double taxation of corporate income and eliminating the bias toward debt financing. Integration ultimately affects investment because elimination of the "double tax" necessarily reduces taxes paid by corporations or by corporate shareholders, and accordingly raises the rate of return on corporate capital. The increased return to capital in the corporate area in turn induces additional physical investment until the return on the marginal investment equals other opportunities, e.g., the market rate of interest. However, as a counterpart to the increased attractiveness of investment in the corporate area, the flow of capital to the noncorporate areas (e.g. housing and agriculture) would be smaller than under present law.

Questions may be raised on the extent to which this possible double taxation of corporate income can be alleviated. Under complete integration, dividends are taxed at the individual level and retained corporate earnings are attributed to corporate shareholders and taxed at the individual level. Thus, under complete integration, there is no separate corporate tax. Under partial integration, a separate tax on corporate income is maintained, and dividends are taxed only once at the individual level.

There are two approaches available to alleviate the double tax on corporate income. Under the partnership method, no tax is levied at the corporate level; all shareholders are treated as implicit recipients of undistributed profits. Thus, each shareholder would include in his taxable income his share of distributed and undistributed profits. Such

tax treatment currently exists for Subchapter S corporations with 10 or fewer partners.

Under the partial integration approach, a separate tax on corporate income is maintained, and dividends are taxed only once at the individual level. Double taxation of dividends is eliminated by either allowing corporations to deduct dividend payments (as interest payments are currently treated) or by allowing taxpayers a credit for the taxes paid on dividends received. Under the credit approach, a taxpayer would "gross-up" his dividend income to reflect taxes already paid at the corporate level, and take a credit for an equivalent amount.

6. Corporate Surtax Exemption and Tax Rates

Present Law

Corporate income is generally subject to a normal tax of 22 percent and a surtax of 26 percent, with the initial $25,000 of taxable income exempt from the surtax. In the Tax Reduction Act of 1975 the surtax exemption was increased to $50,000 and the normal tax was reduced to 20 percent on the initial $25,000 of taxable income. Both changes applied only to the year 1975.

Issues

The increase in the surtax exemption in the Tax Reduction Act of 1975 was included in both the House and Senate bills. The Senate bill included a provision that reduced the normal tax rate from 22 percent to 18 percent and increased the surtax rate from 26 percent to 30 percent. The 2-point reduction in the normal tax rate on the initial $25,000 or taxable income was adopted in conference.

These tax reductions are generally viewed as attempts to provide tax relief to small businesses. The increase in the surtax exemption from $25,000 to $50,000 provides a tax reduction of $6,500 to all corporations with taxable income above $50,000, smaller reduction to corporations with taxable income between $25,000 and $50,000, and no tax reduction for corporations with taxable income below $25,000. Thus 24 percent of this reduction is received by corporations with taxable income below $50,000. In the case of the 2-point reduction in the normal tax on the first $25,000 of taxable income, fifty-seven percent goes to corporations with incomes less than $50,000.

Temporary reductions in corporate tax rates for small corporations generally are not viewed as being as effective in stimulating business investment as increases in the investment tax credit. When a corporation is considering whether to make an investment, it is concerned with what the tax burden will be on the income produced by the investment, income that is usually received over a long period of time. A one-year reduction in corporate tax rates, therefore, has only a small effect on expected after-tax rates of return, so it provides little stimulus to new investment. A permanent reduction in corporate tax rates, however, would increase after-tax returns over the life of a new investment and, therefore, may be as effective at stimulating investment as an increase in the investment credit.

A reduction in corporate tax rates increases the incentive to invest only insofar as it reduces the marginal tax rate; that is, the rate applied to additional income. For example, a corporation with taxable income of $100,000 receives a $6,500 tax reduction as a result of the

increase in the surtax exemption from $25,000 to $50,000. Each additional dollar of taxable income that the corporation would receive from a new investment, however, would still be taxed at a 48-percent rate, and it is this tax rate that the corporation will use in calculating the expected profitability of a new investment.

Increasing the surtax exemption from $25,000 to $50,000 reduces the marginal tax rate for a corporation whose income is between $25,000 and $50,000. A corporation with income below $25,000 receives no tax reduction at all, while a corporation with income above $50,000 receives a $6,500 tax reduction but experiences no change in the tax rate application to additional income. Since 3.7 percent of corporate income is received by corporations with taxable income between $25,000 and $5,000 the increase in the surtax exemption is not likely to induce substantial additional investment.

The 2-point reduction in the normal tax rate on the first $25,000 of income reduces the marginal tax rate for corporations with taxable income below $25,000, which receive 5.4 percent of corporate income, but not for firms with higher income. This proposal is an efficient investment stimulus since most firms experience a reduction in their marginal tax rate.

House Bill

The House bill increased the corporate surtax exemption from $25,000 to $50,000, and reduced the corporate normal tax from 22 to 20 percent on the initial $25,000 of taxable income (the 22-percent rate applies to the second $25,000 of taxable income) for additional years, through December 31, 1977.

7. Employee Stock Ownership Plans (ESOPs)

Present Law

Under present law, employee compensation paid in the form of employer contributions under an employee stock ownership plan (ESOP) is treated as deferred compensation for tax purposes, that is, the employee generally is not taxed on these employer contributions until they are distributed under the plan.

ESOPs are generally designed to be tax-qualified plans. In order to qualify, a plan must, for example, satisfy rules prohibiting discrimination in favor of highly paid employees, and it must meet standards relating to employee participation, vesting, benefit and contribution levels, the form of the benefits, and the security of the benefits. Under the tax law, if a plan meets these requirements, in addition to deferral of employee tax on employer contributions the employer is allowed a deduction (within limitations) for his contributions, the income earned on assets held under the plan is not taxed until it is distributed, special 10-year income averaging rules apply to distributions made in a lump sum, and estate and gift tax exclusions are provided.

An ESOP uses a tax-qualified stock bonus plan [5] or a company stock money purchase pension trust.[6] It is a technique of corporate finance

[5] A qualified stock bonus plan is required to distribute benefits in the form of employer stock.

[6] A pension plan which invests in employer securities, and under which employer contributions are credited to the separate accounts of employees. An employee's benefits under such a plan are based upon the balance of his account.

designed to build beneficial equity ownership of shares in the employer corporation into its employees substantially in proportion to their relative incomes, without requiring on their part any cash outlay, any reduction in pay or other employee benefits, or the surrender of any rights on the part of the employees.

Under an ESOP, an employee stock ownership trust generally acquires stock of the employer with the proceeds of a loan made to it by a financial institution. Typically, the loan is guaranteed by the employer. The employer's contributions to the employee trust are applied to retire the loan so that, as the loan is retired, and as the value of the employer stock increases, the beneficial interest of the employees increases. Of course, if the employer fails to make the required contributions, or if the value of the employer's stock declines, the beneficial interest of the employees declines.

Under present tax law, an employer is entitled to an additional percentage point of the investment tax credit [7] (11 percent rather than 10 percent) if he contributes the additional credit to an employee trust which satisfies the requirements of the Tax Reduction Act of 1975. The ESOP, which may be a qualified or nonqualified plan, must satisfy special rules as to vesting,[8] employee participation,[9] allocation of employer contributions,[10] benefit and contribution limits,[11] and voting of stock held by a trust under the plan.[12] The vesting, allocation, and voting rules are generally considered more favorable to rank and file employees than those which are required for tax qualification.

Issues

Several problems have arisen under the investment tax credit rules designed to encourage the adoption of ESOPs. For example, because the additional investment tax credit is only available for a short period, many employers have not become aware of it in time to establish an ESOP. This lag in recognition of the new provisions and uncertainty as to how they would be applied probably accounts for the modest number of ESOPs established under the investment credit rules.[13] Also, because of the short period during which investments may qualify for the additional credit, some employers have found that the cost of establishing an ESOP under the investment tax credit rules is unreasonably high in relation to the benefits of the plan. Additionally, because the economy has been depressed, some employers have been unable to utilize investment tax credits available under the usual rules, and the additional investment tax credit has not provided an adequate incentive to encourage them to adopt ESOPs.

The investment tax credit recapture and redetermination rules are another factor which has discouraged the adoption of ESOPs. Under

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[7] The additional credit is allowed with respect to qualifying investments made after January 21, 1975, and before January 1, 1977.

[8] Each participant's right to stock allocated to his account under these rules must be nonforfeitable.

[9] The ESOP must satisfy the same participation rules applicable to qualified plans.

[10] An employee who participates in the plan at any time during the year for which an employer contribution is made is entitled to a share of the employer contribution, based upon the amount of compensation paid to him by the employer. Only the first $100,000 of employee compensation is considered for purposes of the plan.

[11] The ESOP is subject to the same benefit and contribution limitations applicable to qualified plans.

[12] Employees must be entitled to direct the voting of employer stock held by the employee trust.

[13] As of February 28, 1976, 30 applications were pending in the IRS for determination letters with respect to ESOPs under the investment credit rules. As of that date, one favorable determination letter was issued under those rules and two cases were closed without the issuance of a letter.

those rules, if a portion of the additional investment tax credit is recaptured or the credit redetermined by the Internal Revenue Service to be a smaller amount than claimed, the employer must bear the cost of repaying the excess credit; he cannot recover it from the employee trust under an ESOP.

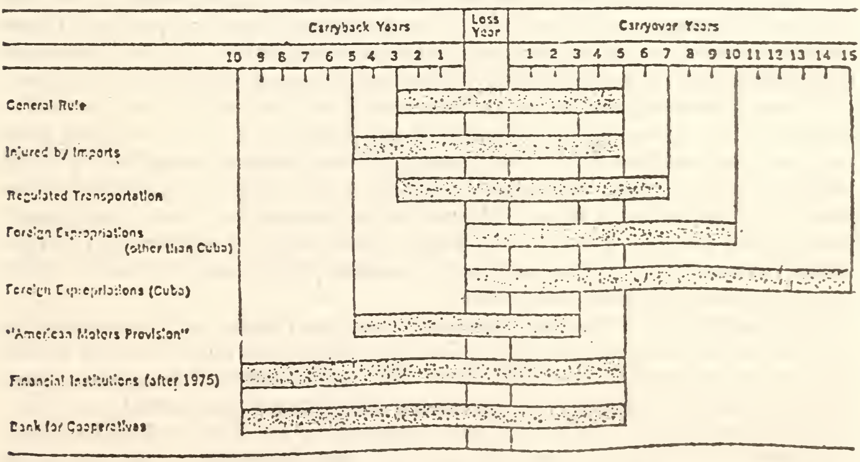
Special problems have discouraged the adoption of ESOPs by electric utilities. Publicly regulated utilities have been reluctant to establish ESOP's under the investment tax credit rules because they are concerned that regulatory commissions will require that the additional investment tax credit be "flowed-through" to customers. If the regulatory commissions take that position, the utilities will be required, in effect, to pay out the additional investment tax credit twice—once to the ESOP and then again to the customers.

8. Net Operating Loss Carrybacks and Carryovers

Present law

Present law, in general, provides that a taxpayer is allowed to carry a net operating loss back as a deduction against income for the 3 years preceding the year in which the loss occurred and to carry any remaining unused losses over to the 5 years following the loss year. This general rule enables taxpayers to balance out income and loss years over a moving 9-year cycle, to the extent of taxable income in the 3 years preceding, and the 5 years following, any loss year. A net operating loss carryback results in a refund of income taxes to the extent that the carryback offsets taxable income previously reported for the carryback years.

CHART 2.—Net operating loss carryback and carryover periods for different categories of taxpayers.



Present law also provides several exceptions to the general 3 year carryback-5 year carryover rule in the case of certain industries or categories of taxpayers, as indicated in chart 2. One exception allows certain regulated transportation corporations to carry back and deduct net operating losses for the usual 3 years and to carry over such losses for 7 years. Another exception prohibits the carryback of a net oper-

ating loss to the extent the net operating loss was attributable to a foreign expropriation loss. However, a 10-year carryover period is allowed for the foreign expropriation loss (15 years in the case of a Cuban expropriation loss).

A third exception, applicable to financial institutions for taxable years beginning after December 31, 1975, lengthens the carryback period for net operating losses to 10 years and allow the usual 5-year carryover period. Similarly, a bank for cooperatives is presently allowed to carry net operating losses back for 10 years and forward for 5 years. A fourth exception is provided for taxpayers which have incurred net operating losses resulting from increased imports of competing products under trade concessions made pursuant to the Trade Expansion Act of 1962. Where a taxpayer has elected to obtain certification as provided by this Act, it is allowed a 5-year carryback period and the usual 5-year carryover period.

Present law also contains a provision designed for American Motors Corporation permitting a 5-year carryback period and a carryover period of 3 years for losses incurred for taxable years ending after December 31, 1966, and prior to January 1, 1969.

Issues

Net operating loss carrybacks and carryovers provide business taxpayers with a form of averaging which, in effect, permits them to share their losses with the government by offsetting these losses against their taxable income in other years (within the prescribed time limitations.) This is generally regarded as equitable since taxpayers are required to share their income with the government by paying income tax when they have profitable years.

However, there have been proposals to revise the present carryback—carryover rules by permitting longer carrybacks or carryover periods and by allowing taxpayers an option to substitute carrybacks for carryovers. Others would provide a longer carry forward period. These proposals stem, in large part, from the fact that in the current economic situation—and in particular in certain depressed industries—taxpayers have incurred substantial losses which they cannot offset fully against the income of other years. Such taxpayers, for example, may not be able to offset fully their losses in the present carryback period because these losses are large and the prior years were either loss years or low income years. Moreover, a number of these companies doubt that they will be able to fully offset such losses through carryovers because they anticipate only modest profits in the future years covered by the present carryover.

Liberalization of the net operating loss provisions is also supported as an effective way to assist temporarily nonprofitable businesses which derive no immediate benefit from the usual capital formation and recovery provisions such as increased investment tax credits, accelerated depreciation deductions, rate reductions or dividend deductions.

Electing to substitute carrybacks for carryforwards.—So far as the taxpayer is concerned, whether a longer carryback or a longer carryforward is desired depends on the business's pattern of income and losses over the years. Taxpayers which have had a very long string of annual losses which extend beyond any feasible carryback period will ordinarily prefer carryforwards because the business will not be in a

position to benefit from longer carrybacks. Similarly, new businesses which, of course, have no income in past years against which to apply carrybacks will generally prefer longer loss carryforwards. However, taxpayers with sufficient income in past years to benefit from carrybacks are apt to prefer carrybacks to carryforwards, particularly since carrybacks provide tax refunds, while obtaining the benefit of carryovers is dependent upon the ability of the business to earn profits in future years. A rule requiring business losses to be carried forward also provides an incentive to the business to operate efficiently so as to generate future income which can absorb the earlier loss.

In order to give taxpayers greater flexibility to adapt net operating loss deductions to their particular circumstances, taxpayers could be given the option of substituting additional carryback years (on top of the existing carryback years) for their presently allowable carryover years. This would give the company the option of taking loss offsets within a prescribed number of years as carrybacks or as carryforwards. Under this approach, for example, instead of the general 3-year carryback—5-year carryforward, a taxpayer might elect to carry back his losses for 8 years with no carryforward, or to carry his losses forward for 8 years with no carryback. If this approach were adopted, longer carrybacks would be frequently elected by taxpayers desiring to secure relatively speedy refunds to bolster their business positions.

Time period covered by carrybacks and carryovers.—In theory, there seems little objection to a longer carryover period except for the fact that the longer the period over which the losses can be offset, the greater the loss in revenue to the government. As a practical matter, however, the longer the carryover period, the greater the likelihood of trafficking in loss corporations.

It is sometimes maintained that longer carrybacks do not result in substantial revenue losses because a taxpayer who utilizes them will have smaller (or no) carryovers in future years. However, a rule which allows taxpayers to carry back losses beyond the present carryback period (3 years) is likely to involve significant loss of revenue because there is no assurance that particular taxpayers will, in fact, have sufficient profits in future years against which to offset such losses. Similarly, longer carryover can also involve revenue losses.

In general, the longer the period over which a loss carryback can be used, the greater are the administrative problems. A long carryback period, for example, requires the recomputation of tax for past years, and the further such past years go back, the greater the problem of recomputing the tax from a taxpayer's old books and records. The present 3-year carryback period appears to have been designed, in part, to correspond with the 3-year period for the statute of limitations for applying tax assessments.

Sales of loss carryovers.—At present, there is substantial "trafficking" in the sale of loss carryovers, primarily for tax purposes. Profitable business enterprises, for example, may now acquire businesses with loss carryovers mainly to make use of these loss carryovers against the profits of their businesses.

Under the present law, where the loss corporation is the acquired corporation in a taxfree reorganization or in a sale of stock to new owners, there are limitations on the availability of the acquired cor-

poration's loss carryforwards to the acquiring corporation. The principal limitations are:

(1) If more than 50 percent of the stock is purchased within 2 years and by the end of that period the business of the acquired corporation has changed, then the loss carryforwards are eliminated (sec. 382(a)).

(2) If all the assets of the corporation are acquired in a tax-free merger, then if the shareholders of the acquired corporation obtain less than a 20-percent interest in the acquiring corporation, the loss carryforwards are reduced by 5 percentage points for each percentage point less than 20 that the acquired company's shareholders own in the acquiring company. (For example, if the acquired company's shareholders obtain a 12-percent interest, only 60 percent of the loss carryovers are allowed. (sec. 382(b).)

(3) If a corporation is acquired with a principal purpose to evade or avoid income tax, then the loss carryovers may be disallowed in whole or in part (sec. 269).

(4) If one corporation acquires more than 80 percent of the stock of another (either in a taxable or a tax-free acquisition) and then files a consolidated return, the preacquisition losses of the corporation acquired can be used only against the income of that corporation.

However, while these limitations restrict, they by no means eliminate the advantages of "trafficking" in loss carryforwards from an acquired corporation.

Available data suggest that such trafficking in loss carryovers is extensive. In 1974 there were 224 advertisements in the Wall Street Journal relating to the sale or purchase or loss carryover corporations. A total of $250 million of loss carryovers were involved in those advertisements in this group that cited dollar figures, and inclusion of the cases in which dollar figures were not cited undoubtedly would have boosted this figure to a much higher level. Moreover, the $250 million figure does not reflect the substantial volume of transactions in loss carryovers which are consummated without being advertised.[14]

9. Personal Savings

Present law

Under present law, personal savings are made out of taxed income—that is, the income that individuals save is subject to individual income tax as is any investment income on such savings. In this respect, the income tax applies equally to income regardless of whether it is spent on consumption items or saved.

However, different tax treatment is accorded to certain income saved for retirement purposes under pension, profit-sharing, and other plans that qualify under the tax law and therefore do not discriminate in favor of highly paid employees and excentives as compared with rank and file employees. Employees covered by such plans do not include in their current taxable income contributions made for them by their employers to these plans. Instead, they postpone payment of tax until they receive the benefits, generally on retirement. In addition, invest-

[14] See testimony of Michael Waris, Ja., in Public Hearings before the Committee on Ways and Means, House of Representatives, 94th Congress, 1st Session, on the Subject of Tax Reform, Part 5 (July 29–31, 1975), page 3589.

ment earnings on the amounts contributed to qualified pension, etc., plans are exempt from tax when earned by the plan and are not taxed until they are paid out to the covered individuals, at which time they are taxed at the individual rates. This provides considerably more advantageous tax treatment to savings in qualified pension plans than to savings out of taxed income since it permits the employee covered by the pension plan to defer payment of tax for substantial periods of time. This deferral provides significant interest savings. Additionally, by deferring tax until the time that he receives the pension benefits, the covered individual generally reduces his tax since his income, and hence applicable tax rates, are generally lower at the time of retirement than during his working career. Also, if the covered individual dies before he receives the amounts he is entitled to, the remainder is not included in his estate even though it is payable to his heirs.

Since 1963, self-employed individuals may choose to be covered by so-called H.R. 10 plans if they provide comparable coverage and benefits for their employees. This permits self-employed people (including those who have no employees) to deduct limited contributions to a pension plan on their own behalf and to defer payment of tax on such retirement savings until they receive the benefits. Since 1974 the deductible pension contributions of the self-employed on their own behalf are limited to the lesser of 15 percent of earned income or $7,500 a year.

In addition, since 1974 individuals not covered by pension plans may set up individual plans for themselves (individual retirement accounts, or IRA's). Individuals are permitted to deduct their contributions to these IRA accounts up to the lesser of 15 percent of their earned income or $1,500 a year. The amounts placed in IRA accounts together with the investment earnings on these amounts remain free of tax until they are withdrawn, generally upon retirement, when they are included in the individual's tax income. This permits individuals establishing IRA accounts to receive much the same favored benefits accorded to individuals who are covered by employer-established pension plans.

Issues

Present concern about the possibility of capital shortages to meet the Nation's future needs has stimulated the study of tax proposals designed both to increase personal savings and to provide greater equality in the tax treatment of saving. Such proposals could extend the favorable tax treatment now provided for retirement savings for other purposes.

Deferred tax treatment for personal savings for purposes other than retirement is supported on the ground that savings for such purposes as the education of children, the purchase of a home, and financial contingencies merit tax assistance just as much as retirement savings.

There are practical ground, however, for the favorable tax treatment of pension savings financed by employer contributions that do not apply to other kinds of savings. To a very considerable extent, the present deferred tax treatment of employer contributions to qualified pension plans evolved in recognition of the practical difficulties of taxing covered employees currently on such contributions, particularly since employees may not actually receive benefits from pension plans until long after the contributions are made. A similar considera-

tion for deferred treatment does not apply to the individual's own savings in such assets as bank accounts, stocks, and a house, since, as the owner, he has already directly received these assets.

Proposals to extend deferred tax treatment for income saved for purposes other than retirement would involve a substantial revenue loss. The exact revenue loss would depend on the specifics of the program adopted.

Extending deferred tax treatment beyond the pension area to individual savings generally could fundamentally change the nature of the individual income tax. Any extension of deferred tax treatment to specific types of savings would create an additional precedent for extending similar treatment to other kinds of personal savings. Ultimately, such extensions could lead to a generalized deduction for savings which would tend to change the individual income tax from a tax on income to one on spending. This, it is argued, would be contrary to the principle of taxation based on the ability to pay since high income individuals save more than low income individuals and hence would receive larger tax deductions for personal savings. Such a tendency for savings deductions to favor high income individuals might be offset to some degree by plaicng relatively low maximums on the amount of savings eligible for tax deductions.

There is also an important question as to how effective the proposed deferred treatment would be as a means of increasing the total volume of savings. For many years, economists have questioned whether changes in interest rates significantly affect the volume of personal savings.

If a deferred tax treatment were granted to personal savings without regard to whether such savings represented an increase over the amounts that would be saved in any event, much of the resulting revenue loss would be wasted since it would not have stimulated additional savings. This could be dealt with by restricting the savings which are deducted to those savings which are considered additional savings. However, such a procedure would be administratively difficult to put into practice. It would appear, for example, that the presence of such additional personal savings could be demonstrated only through a comparison of the individual's assets for successive years; it cannot be demonstrated merely by examining the size of savings in the particular savings items eligible for the deferred tax treatment because it would be possible for the taxpayer to shift his existing savings from those forms not eligible for the favored tax treatment to those forms which are eligible.

Additionally, whether an increase in personal savings is desirable depends to a considerable extent on the economic setting in the future. Perhaps the most important factor in encouraging total savings and the growth of capital is a generally prosperous and relatively high employment economy. Experience has shown that total savings are generally high when GNP is growing but that savings tend to drop in periods of recession. Therefore, the effectiveness of provisions to encourage personal savings through favored tax treatment may depend on the contribution that this tax treatment would make toward a prosperous and fully employed economy. If the economy is growing it may be appropriate to encourage greater savings to combat inflation; on the other hand, if the economy is faltering, attempts to en-

courage greater savings could merely depress the economy still further and reduce total saving.

House Bill

The House bill contains two provisions which affect personal savings. The first, Sec. 1501, which provides for tax-free rollovers for employees who received payments resulting from termination of their retirement plan, became law on April 15, 1976.

The second, Sec. 1502, provides that an individual who is an active participant in a qualified defined benefit (pension) plan, a qualified defined contribution (profit-sharing, stock bonus, etc.) plan, or an annuity contract described in Code section 403(b) would be permitted to deduct (1) his contribution to an individual retirement account (IRA) and (2) his employee contribution to his employer's qualified plan, but only if that qualified plan was in existence on September 2, 1974. The aggregate contribution to IRA's and qualified plans could not exceed the present IRA contribution limit (the lesser of 15 percent of earned income or $1,500), reduced by the amount of his employer contributions allocable to that individual. This provision would not apply to an individual for any year when he was an active participant in a Government plan.

These provisions would apply for taxable years beginning after December 31, 1975.

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